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IN THE

Supreme Court of the United States

OCTOBER TERM, 1954

No. 114

GENERAL AMERICAN INVESTORS COMPANY, INC.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER

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Opinion Below

The opinion of the Tax Court (R. 3) is reported at 19 T. C. 581. The opinion of the Court of Appeals (R. 13) is reported at 211 F. 2d 522.

Jurisdiction

The judgment of the Court of Appeals was entered on March 9, 1954 (R. 19-20). The petition for certiorari was filed June 4, 1954 and was granted October 14, 1954 (R. 26).

The jurisdiction of this Court rests upon 28 U. S. C. § 1254 (1) and Section 1141(a) of the Internal Revenue

Code of 1939. See Section 7851(b)(1) of the Internal Revenue Code of 1954.

Question Presented

In 1948, petitioner received $170,038.04 from a director and from a stockholder in satisfaction of liabilities imposed on them by Section 16(b) of the Securities Exchange Act of 1934 as made applicable by Section 30(f) of the Investment Company Act of 1940.

The sole question presented is whether the amount received by petitioner is includible in petitioner's "gross income".

Constitutional Provisions, Statutes and Regulations Involved

The Sixteenth Amendment to the Constitution of the United States:

> "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

Section 22(a) of the Internal Revenue Code of 1939:

> "(a) GENERAL DEFINITION.—'Gross income' includes gains, profits, and income derived, from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property;

also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever . . ."

U. S. Treas. Reg. 111, Sec. 29.22(a)-1:

"*What included in gross income.*—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. (See sections 22(b) and 116.) In general, income is the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through sale or conversion of capital assets. Profits of citizens, residents, or domestic corporations derived from sales in foreign commerce must be included in their gross income; but special provisions are made for nonresident aliens and foreign corporations by sections 211 to 237 inclusive, and, in certain cases, by section 251, for citizens and domestic corporations deriving income from sources within possessions of the United States. Income may be in the form of cash or property."

Section 30(f) of the Investment Company Act of 1940, 15 U. S. C. § 80a-29(f):

"(f) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of outstanding securities (other than short-term paper) of which a registered closed-end company is the issuer or who is an officer, director, member of an advisory board, investment adviser, or affiliated person of an investment adviser of such a company shall in respect of his transactions in any securities of such company (other than short-term paper) be subject to the same duties and liabilities as those imposed by section 16 of the Securities Exchange Act of 1934 upon certain beneficial owners, directors, and officers in respect of their transactions in certain equity securities."

Section 16(b) of the Securities Exchange Act of 1934, 15 U. S. C. § 78p(b):

> "(b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection."

Statement

The pertinent facts, as they were found by the Tax Court (R. 3-6), are as follows:

Petitioner is a registered closed-end investment company as defined in the Investment Company Act of 1940.

On or about April 1, 1944, one of petitioner's directors acquired warrants to purchase shares of petitioner's common stock at five different prices ranging from $10 to $20 per share. On or about the same date, a second individual (referred to as "stockholder"), who at all times between June 5, 1945 and June 17, 1946 owned more than 10% of the then outstanding warrants, also acquired warrants to purchase shares of petitioner's common stock at similar prices.

More than a year and a half after acquisition of the warrants, viz., on December 4 and 18, 1945, the director and the stockholder exercised certain of their warrants and purchased shares of petitioner's common stock at the average purchase price of $13.75 per share. The director exercised warrants to purchase 12,228 shares and the stockholder 28,532 shares. These purchases upon the exercise of warrants were the only purchases of common stock of petitioner by the director and the stockholder from June 5, 1945 to June 17, 1946.

Between June 5, 1945 and June 17, 1946, the first date being more than a year after acquisition of the warrants but both dates being within the period of six months before and six months after the exercise of the warrants, the director, individually and through a partnership of which he was a member, and the stockholder, individually and through a partnership of which he was a member, sold on the New York Stock Exchange 12,228 plus shares and 27,027 shares, respectively, of petitioner's common stock.

Pursuant to Section 30(f) of the Investment Company Act of 1940 and Section 16(b) of the Securities Exchange Act of 1934, the director and the stockholder were required to pay to petitioner certain "profits", as that term is used in the Securities Exchange Act of 1934, realized upon the sales and purchases, or purchases and sales, of shares of petitioner's common stock between June 5, 1945 and June 17, 1946, inclusive. The "profits" were computed by subtracting from the highest amounts realized by the director and

the stockholder on their sales of the stock the average amounts the director and the stockholder had paid to petitioner on the exercise of the warrants plus the average cost of the warrants themselves. The "profits" were paid by the director and the stockholder to petitioner upon the advice of counsel and without litigation.

The "profit" required to be paid petitioner by the stockholder as a result of such transactions was computed to be $129,362.95, and the "profit" required to be paid petitioner by the director as a result of such transactions was computed to be $81,092.33. The director paid petitioner $40,417.24 on March 9, 1946, and he paid his remaining $40,675.09 and the stockholder paid his entire $129,362.95, which together total $170,038.04, to petitioner in 1948.

Of the proceeds received by petitioner upon the exercise of the warrants, petitioner credited $1 per share to its capital account and the balance to its capital surplus account. The $40,417.24 received from the director in 1946 was in that year credited to petitioner's capital surplus account. The amounts received from the director and stockholder in 1948 were recorded by petitioner in its cash book as "Capital Surplus—add'l amt recd in connection with common stock issued in 1945", and the aggregate amount so received in 1948 was credited to petitioner's capital surplus account. Thereafter, upon notification by respondent that these 1948 receipts should be returned as income, petitioner debited capital surplus account and credited a receipts-in-suspense account with these amounts and thereafter, at the close of 1948, debited the latter account with a reserve for taxes and legal expenses and transferred the balance to capital surplus.

The Tax Court held, with one judge dissenting, that the $170,038.04 received by petitioner in 1948 from the director and the stockholder was gross income to petitioner, against which petitioner was allowed to deduct an expense of $13,000 incurred as legal fees in recovering that amount.

The decision of the Tax Court was affirmed by the Court of Appeals for the Second Circuit.

Summary of Argument

We do not urge that this Court should be bound by a narrow interpretation of its own prior definition of income. We do urge that the Court adhere to the historical concept of the nature and distinguishing characteristics of income which it long ago adopted and has repeatedly followed and from which it has never departed. Under that concept, which is much broader than the concept of income for tax purposes in Great Britain and Canada, receipts or accessions to wealth are not income unless in a basic generic sense they are derived from or are attributable to some act or effort (labor) or some asset (capital) of the taxpayer or a combination of the two.

Under this historical concept, the receipt here in question is not income. The suggestion, rejected by the Court below, that it is in the nature of income because Section 16(b) of the Securities Exchange Act of 1934 characterizes it as a "profit" "realized" by the "insider" which is to "inure" to the corporation, will not stand analysis. The taxation as income of the receipt here involved cannot be reconciled with the nontaxation of punitive or treble damage recoveries. If receipts of the latter sort do not constitute income, then *a fortiori* the receipt here involved is not income, although the reverse does not necessarily follow.

The broad conceptual dividing line heretofore drawn by this Court is the only rational line that can be drawn between what is and what is not income for tax purposes. Unless this Court here adheres to the historical dividing line, it would logically follow either that there is no guiding rule whatsoever for the determination of income other than a judicial "hunch" as to common understanding or public policy considerations or that, contrary to common under-

standing and to many decisions of this Court and other Courts, Congress would have the untrammeled power to tax as income every realized enrichment even though it be received as a gift, or as a contribution to capital, or as a bequest, devise or inheritance, or as the result of a canceled stock subscription, or as treasure-trove accidentally found, or as an unforeseen and unsought for windfall of any kind whether or not forced upon the recipient by law for the purpose of penalizing another. It is submitted that receipts of such unusual character are not and have not been commonly thought to be income for tax purposes and, though Congress may subject them to excise or transfer taxation, as it does with respect to gifts and estates, it neither has subjected them nor may it subject them to income taxation under an income tax statute. Ample room remains for the operation of the income tax in the income area already broadly expanded to include all receipts from business or personal activities in pursuit of gain or derived from capital or in return for almost any consideration whatsoever.

ARGUMENT

I.

A payment received by a corporation pursuant to Section 30(f) of the Investment Company Act of 1940 and Section 16(b) of the Securities Exchange Act of 1934 is not income to the corporation.

In the following cases in addition to the present one, the receipt of a Section 16(b) payment has been held to constitute income to the corporate recipient. *Park & Tilford Distillers Corp.* v. *United States*, 107 F. Supp. 941 (Ct. Cl. 1952), cert. denied 345 U. S. 917 (1953); and *Noma Electric Corp.*, 12 T. C. M. 1 (1953), on appeal to the Court of Appeals for the Second Circuit.

On the other hand, the Court of Appeals for the Third Circuit has held that punitive or treble damage recoveries under the antitrust laws are not income, *Commissioner* v. *Glenshaw Glass Company* and *Commissioner* v. *William Goldman Theatres, Inc.*, 211 F. 2d 928 (3rd Cir. 1954), affirming 18 T. C. 860 (1952) and 19 T. C. 637 (1953), whereas the Court of Appeals for the Seventh Circuit has held the contrary. *Commissioner* v. *Obear-Nester Glass Company*, —— F. 2d —— (7th Cir., Nov. 15, 1954), 1954 CCH Fed. Tax Reporter, ¶ 9675, reversing 20 T. C. 1102 (1953). This Court has granted the petition for certiorari in the *Glenshaw Glass* case (Oct. Term, 1954, No. 199); a petition for certiorari has been filed in the *Obear-Nester* case (Oct. Term, 1954, No. 478).

While the Tax Court and the Courts of Appeals for the Second and Third Circuits indicated in these decisions that the foregoing two types of cases might be distinguishable, each attempted to distinguish or indicated the possibility of distinguishing the case in the other Court on grounds which the other Court either expressly rejected or failed to recognize. The Court of Claims and the Court of Appeals for the Seventh Circuit, on the other hand, thought that taxability of Section 16(b) payments cannot be reconciled with nontaxability of punitive or treble damage recoveries.

A. *The nature of a Section 16(b) payment.* Petitioner, acting under compulsion of Section 16(b) of the Securities Exchange Act of 1934 as made applicable by Section 30(f) of the Investment Company Act of 1950,[1] received sums of money from a director and a 10% stockholder. Petitioner did not obtain these receipts in pursuit of any gain. It did not expect them. It had no control over the circumstances

[1] For the purpose of this brief the liability imposed by Section 30(f) of the Investment Company Act of 1940 and the liability imposed by Section 16(b) of the Securities Exchange Act of 1934 will be considered the same, and the phrases "Section 16(b) liability" or "Section 16(b) payment" when used herein is intended to refer to liability or payment under either or both of said sections, whichever is appropriate.

which led to the receipts. It gave nothing whatsoever in return. No effort or activity on its part generated the receipts. It was in legal effect forced to accept the payments irrespective of its own wishes or conduct. It could not waive, reject or return the money because any one of its stockholders could compel it to receive the money willy-nilly. There was no periodicity about the receipts. The receipts had no relation to petitioner's property or its business activity or to any act or promise or undertaking or forbearance on its part. The receipts were not in substitution for or in replacement of any corporate loss of profits or property resulting from wrongful use of petitioner's assets, opportunities or rights or otherwise, such as are dealt with in some cases. *Arcadia Refining Co.* v. *Commissioner,* 118 F. 2d 1010 (5th Cir. 1941); *Raytheon Production Corp.* v. *Commissioner,* 144 F. 2d 110 (1st Cir. 1944), cert. denied 323 U. S. 779 (1944); *Durkee* v. *Commissioner,* 162 F. 2d 184 (6th Cir. 1947). Nor were they obtained for any consideration whatsoever, such as the release of claimed rights or otherwise, as has been involved in certain other cases. *Sterling* v. *Commissioner,* 93 F. 2d 304 (2d Cir. 1937), cert. denied 303 U. S. 663 (1938); *Lyeth* v. *Hoey,* 96 F. 2d 141 (2d Cir. 1938), rev'd on other grounds, 305 U. S. 188 (1938); *White* v. *Thomas,* 116 F. 2d 147 (5th Cir. 1940), cert. denied 313 U. S. 581 (1941).

Petitioner received the money because Congress, interested as a matter of public policy in deterring possible injury to stockholders through misuse by insiders of inside information, decided to penalize the insider who purchases and sells or sells and purchases equity securities of his corporation within six months by depriving him of any "profit" he might realize therefrom, wholly without reference to whether any inside information was used and even without reference to whether the so-called "profit" is really attributable, in a case such as this, to appreciation in value of stock purchase warrants held for a period considerably longer than six months. Congress might have required the so-called "profit" to be forfeited to the Fed-

eral Government or it could have required the forfeited amounts to be distributed among the stockholders for whose protection the provision was enacted. It chose, however, the more convenient course of requiring the forfeited amounts to be paid to the corporation, thus indirectly benefiting all stockholders, and gave the stockholders a right to enforce collection if the corporation failed to do so. In a real sense and in economic effect, from the standpoint of the corporate recipient they resemble legally enforced capital contributions for the benefit of the stockholders. From the standpoint of the insider, the amounts in question were penalties, *Smolowe* v. *Delendo Corp.*, 136 F. 2d 231 (2d Cir. 1943), cert. denied 320 U. S. 751 (1943), which the insider could not deduct from gross income for Federal income tax purposes. *William F. Davis, Jr.*, 17 T. C. 549 (1951); *W. L. Dempsey*, 10 T. C. M. 936 (1951). In any event, the circumstances giving rise to the obligation to pay and receive were entirely beyond petitioner's contemplation or control, and the payments received did not represent compensation for any injury inflicted on it or a restitution of profit from wrongful use of its assets, opportunities or rights. In short, they had nothing whatsoever to do with its property or its labor or any action or inaction of any kind on its part.

In the present case the only purchases by the insiders were made directly from the corporation upon the exercise of warrants; there were no purchases in the open market (R. 4-5). When the insiders made sales resulting in Section 16(b) liability, the economic effect was to increase their cost of the shares acquired upon exercise of the warrants and, by the same token, to increase the subscription price received by the corporation for the stock. The corporation credited the amounts received to capital surplus accordingly (R. 5-6). In essence, therefore, the corporate receipt was very much akin to the receipt of part of the subscription price of newly issued shares—which is not

income. Treas. Reg. 111, Sec. 29.22(a)-15. Whether or not the requirement of Section 16(b) can be said to be part of the subscription contract (*cf. Hutchison* v. *Ward*, 114 N. Y. App. Div. 156, 158, 99 N. Y. Supp. 708, 709 (1st Dept. 1906)), it would seem especially appropriate to treat the character of the Section 16(b) payment in this case as no less capital in nature than a corresponding adjustment of the subscription price would have been had the subscription contract itself expressly required the payment.

B. *The taxability of a Section 16(b) payment cannot be reconciled with the nontaxability of punitive or treble damage recoveries.* The Court below, affirming the Tax Court, held that the sums received by petitioner constituted income within the meaning of Section 22(a) of the Internal Revenue Code. The Court's reasoning was in substance that there is no common principle or touchstone by the application of which one may infallibly determine what is and what is not income in a given case; that an empirical case-by-case approach must be adopted; that no considerations of policy affect the case one way or the other since the purpose of Section 16(b) will be served equally well whether or not the payments are held to be income to the recipient corporation; that, taking the words "gains or profits and income from any source" in their plain, popular meaning, the Section 16(b) payments constituted income—the petitioner having unrestricted discretion to use the funds for any purpose whatsoever and they being in no sense donations or contributions to capital, payments by way of restoration of lost capital or compensation for any loss suffered by petitioner.

With regard to the cases holding punitive and treble damage recoveries not income, the Court said policy considerations may in the end there play a decisive or persuasive role; but the Court refused to express any opinion thereon, pointing out that such policy considerations may perhaps have no relevance and the Court of Claims may be

right in the *Park & Tilford Distillers* case in saying those cases were wrongly decided.

In holding that punitive and treble damage receipts over and above actual damages do not constitute income, the Court of Appeals for the Third Circuit, in *Glenshaw Glass*, rejected the government's argument that all money or property coming into a person's hands is taxable as income unless specifically exempted by statute, saying it had found no case in which the Court did not look to source as at least coloring or bearing upon the incidence of taxation. Paying considerable allegiance to this Court's historical definition of income and to the requirement that "income" be interpreted as used in common speech, the Court said that the payments to the taxpayers in the cases before it could not fairly be regarded as products of capital or labor and that in the Court's view the ordinary man regards income as something which comes to him from what he has done, not from something which is done to him, and would not regard punitive damages, a mere windfall, as income. Though the Court said punitive damages seem to be *sui generis*, its reasons for holding them not to be income are strikingly applicable to a Section 16(b) payment also. It made the following points in favor of nontaxability of punitive damages (211 F. 2d at 933):

"By definition they are not compensatory." It can equally be said that a Section 16(b) payment is not compensatory.

"They certainly possess no periodicity." This is true also of a Section 16(b) payment.

"They are not derived from capital, from labor or from both combined and assuredly they are not profit gained through the sale or conversion of capital assets." This too is equally true of a Section 16(b) payment.

Punitive damages "smack of donations made to the individual by the State, by operation of law. A person does

a prohibited act to another injuring him. The injured individual is subsequently enriched by a gift taken from the pocket of the injuring party by virtue of law. There is no *quid pro quo*. An analogy seems to us to lie in those cases where contributions are made by the sovereign in the general public interest to an individual. . . . The taxpayers have recovered because the sovereign has seen fit to punish gross behavior for the good of the public. There are naked exactions by the sovereign which go to the injured corporations rather than to the fisc. There is vague likeness to a fine exacted by the sovereign but which goes to the taxpayer." This reasoning is applicable *a fortiori* to a Section 16(b) payment, for in such case, unlike the treble damage case, no injury to any corporate interest need be shown; a class of behavior is punished as gross even though no specific injury occurs. Of course, the corporate recipient of a Section 16(b) payment may in some situations be injured by the insider's actions through impairment of stockholder relations and damage to good will. But the payments in both cases are dictated by the sovereign and in the punitive and treble damage cases are above and beyond any injury.

It is submitted, therefore, that there is no rational basis upon which Section 16(b) payments can be held to be income and punitive damages held not to be income.

C. *Invalidity of attempted distinction based on the language of Section 16(b).* The Court of Appeals in *Glenshaw Glass*, placing particular emphasis upon the concurring opinion of the Tax Court in the present case (R. 11-12), attempted to distinguish the present case on the ground that the making of a profit by the insider is the mainspring of Section 16(b) and that under the operation of the statute, which provides that any "profit realized" by an insider shall "inure to" the issuer, all the stockholders receive via the corporate entity the profit made by the prohibited transaction. However, the Court below in the present case and the Court of Appeals for the Seventh Circuit in the

recently decided *Obear-Nester* case held that such reasoning will not bear analysis. And with this the Commissioner has indicated his accord.[2]

This is clearly correct. Section 16(b) in referring to "any profit realized" speaks of profit realized by the insider; it is the insider's profit which the statute says "shall inure to and be recoverable by" the issuer. Simply because an item represents profit to one person, it does not follow that it also represents a profit to another to whom the law requires the first person to pay it over. The provision that the insider's profit shall inure to the corporation is simply a device to insure that he shall not derive economic advantage from short-term transactions. While profits technically received by one person may be imputed to another in appropriate circumstances under the doctrine of such cases as *Lucas* v. *Earl,* 281 U. S. 111 (1930), *Helvering* v. *Clifford,* 309 U. S. 331 (1940), and *Helvering* v. *Horst,* 311 U. S. 112 (1940), it is implicit in the cases that the income is taxable only to the person to whom it is imputed and not to the recipient as well.

In the Section 16(b) cases, respondent insists that the insider is taxable on any gain realized in connection with his security transactions, even though the transactions give rise to liability under Section 16(b), *I. T. 4069,* 1952-1 C. B. 28, and the insider cannot deduct the Section 16(b) payment for income tax purposes since it is a penalty. *William F. Davis, supra.* It is fundamentally inconsistent to tax the so-called "profit" to the insider and at the same time to tax it to the petitioner because the statute says it shall "inure" to petitioner.

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[2] In footnote 10, page 30, of his brief on appeal in the *Obear-Nester* case, the Commissioner said: "The distinction drawn by the Third Circuit seems to be that under the statute involved in the *Park & Tilford Distillers Corp.* and *General American Inv. Co.* cases the profits were required to be passed on, and inured, to the corporation. But as the Second Circuit stated in its *General American Inv. Co.* decision, such reasoning 'will not bear analysis,' for the 'payments were not "profits" to *petitioner,* although they represented "profits" realized by the director and the stockholder' (italics supplied). (P. 524.) Obviously, the payments were just as much a windfall to the *taxpayer-corporation* as were the punitive damages in the present case."

Moreover, the amount of "profit realized" by the insider for the purpose of Section 16(b) has no necessary relation to the amount of profit, if any, realized by the insider for income tax purposes. The former is arrived at by calculating the maximum "profit" that can be calculated without regard to the profit or loss on the particular stock sold and is not limited to the profit, if any, actually realized as determined under the income tax law. The amount of a Section 16(b) payment is measured under the statute by the excess of the highest sales prices of shares sold during a six months' period over the lowest purchase prices of shares purchased during such period, without regard to the identity of the shares or certificates purchased or sold and without regard to intervening loss transactions. See *Smolowe* v. *Delendo Corp., supra.* In other words, it is a theoretically computed figure having no relation to any actual or taxable gain or loss of the insider. The insider may have suffered a capital loss for tax purposes and have a profit payable to the corporation under Section 16(b). Thus, for example, suppose an insider owns stock purchased years ago at $100 per share. The market steadily declines. He sells his shares at $75, taking a tax loss of $25 per share. Five months later he repurchases an equivalent number of shares at $50 per share. His tax loss is not affected, but he must pay the corporation $25 per share under Section 16(b),—and this notwithstanding that all information available to him and affecting his action was public knowledge and notwithstanding further that he realized no income whatsoever within the meaning of the tax laws. It therefore seems wholly fallacious, in determining the status to the recipient of a Section 16(b) payment, to be influenced by the fact that a so-called "profit realized" by the insider is referred to as the measure of the amount he is required to pay over to the issuer.

Finally, if it be said that a Section 16(b) payment should be income to the recipient corporation simply because the statute says it is a "profit realized" by the in-

sider that the corporation to which it "inures" must pay tax upon, the nature of the income in the hands of the corporation should be the same as in the hands of the insider who realized it. If it was a long-term capital gain to him, it should be the same to the corporation. But this is not what is being attempted nor would it be a feasible approach for the reasons above given.

Whether or not a Section 16(b) payment constitutes income to the corporate recipient accordingly depends, as in the punitive damage cases, upon what is meant by income for Federal income tax purposes.

D. *The meaning of income for Federal income tax purposes.* Section 22(a) of the Internal Revenue Code defines gross income to include:

> ". . . gains, profits and income derived from salaries, wages or compensation for personal service . . . businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from . . . securities, or the transaction of any business carried on for gain or profit, *or gains or profits and income derived from any source whatever.*" (Emphasis supplied.)

Since 1867 taxable income has been defined by statute in substance to include "gains or profits and income derived from any source whatever". See Internal Revenue Act of 1867, 14 Stat. 477. This part of the definition survived the Sixteenth Amendment, adopted in 1913, which gave Congress the "power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States".

Section 22(a) does not purport to include in gross income all receipts or accessions to wealth. It limits the inclusion to income and, although it illustrates by sources the type of thing Congress had in mind, it makes no attempt

to define income. Congress left to the courts the interpretation of that term and its application to the myriad of unforeseeable factual situations that might arise.

What then is income? Economists have differing conceptions, such as the "service-flow" in consumption theory, the "recurrent receipts" theory and "the net addition to economic power" or the so-called "net accretion" theory. For the practical purposes of income taxation, is the meaning of the term "income" to be controlled by any of these differing economic abstractions? Or is it not rather to be arrived at one on some rational basis in keeping with popular concepts of income?

In Great Britain, where use of an income tax far antedated its use in the United States, the tax has been historically imposed on a schedular basis according to sources and there, as in Canada where the schedular system is not followed, taxable income does not include all realizable wealth which in a physical sense comes in; its meaning is limited to include only amounts arising or resulting from the pursuit of gain. La Brie, *The Meaning of Income in the Law of Income Tax* (University of Toronto Press), 1952, p. 21. Windfalls and other enrichments—even capital conversions—not obtained in the pursuit of gain are not regarded as income. *Cf., e.g., Income Tax Commissioner, Bengal* v. *Shaw, Wallace & Co.*, [1932] I. L. R. 59 Calc. 1343, 1350, P. C.; *Ryall* v. *Hoare*, [1923] 2 K. B. 447, 454; *Graham* v. *Green*, [1925] 2 K. B. 37; *Bengon* v. *Thorpe*, [1928] 14 Tax Cas. 1, 13.

In the United States, this Court has had occasion several times, both before and after adoption of the Sixteenth Amendment, to consider the meaning of income for tax purposes. In *Stratton's Independence* v. *Howbert*, 231 U. S. 399 (1913), which involved the 1909 corporation excise tax based on income received from all sources, this Court defined income (p. 415) as "the gain derived from capital,

from labor, or from both combined. . . ." This same definition was adopted in *Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 179, 185 (1918), in determining the treatment of the proceeds of sale of capital assets under the 1909 excise tax act. And in *Eisner* v. *Macomber*, 252 U. S. 189 (1920), this Court again faced the problem and adopted the earlier definition, adding to it the words "provided it be understood to include profit gained through sale or conversion of capital assets". In *Merchants' Loan & Trust Company* v. *Smietanka*, 255 U. S. 509 (1921), involving applicability of the 1916 income tax act to gain realized by a trustee upon sale of assets received from a decedent, the Court reviewed the preceding holdings and said (p. 519):

> "In determining the definition of the word 'income' thus arrived at, this court has consistently refused to enter into the refinements of lexicographers or economists and has approved, in the definitions quoted, what it is believed to be the commonly understood meaning of the term which must have been in the minds of the people when they adopted the Sixteenth Amendment to the Constitution. . . . Notwithstanding the full argument heard in this case and in the series of cases now under consideration we continue entirely satisfied with that definition. . . ."

Under the foregoing definition, a receipt to constitute income must have been derived from capital or labor or from their combination. These terms, expressing basic concepts, are of course to be interpreted broadly. But where it cannot be said that a receipt is the product of the capital of the taxpayer (or in lieu of such product, as in the case of discount of rentals to which a property owner is entitled), or the product of his labor (*i.e.*, the return for some action, effort, service, forbearance or other consideration on his part), it is not income, even though an accession to wealth results.[3]

[3] In some cases, but only under a specific statutory income tax pattern, there may be in effect a shifting of tax on the product of the capital or labor

This is a profoundly perceptive definition. An income tax is not a tax on increases in wealth however occurring. Nor is the income tax to be read as if it were the only means by which our government can or has sought to raise revenues. It is, taken at its most comprehensive, a tax upon a particular mode by which increase in wealth occurs. Other taxes, such as those on gifts and estates, the excises on sales, reach other modes in which economic increments occur. Ingenuity has not yet suggested a better definitional base for the income tax than that reflected in this Court's historical definition not only because it defines income in socially significant and empirically satisfactory terms but also because there is no evident stopping point beyond that definition short of taxing any increase in wealth however occurring.

So far as we are aware, this Court has never questioned the soundness of this basic concept of the characteristic and distinguishing attributes of income for tax purposes. On the contrary, in other cases and indeed as recently as 1952 this Court has repeatedly applied and adhered to this historical concept of income. See *Helvering* v. *Griffiths*, 318 U. S. 371 (1943), in which this Court refused to overrule *Eisner* v. *Macomber; Merchants' Loan & Trust Co.* v. *Smietanka, supra; Bowers* v. *Kerbaugh-Empire Co.*, 271 U. S. 170 (1926); *Taft* v. *Bowers*, 278 U. S. 470 (1929); *United States* v. *Safety Car Heating Co.*, 297 U. S. 88 (1936); *Commissioner* v. *Culbertson*, 337 U. S. 733 (1949); and *Rutkin* v. *United States*, 343 U. S. 130 (1952). To be sure, in *United States* v. *Kirby Lumber Co.*, 284 U. S. 1 (1931), Mr. Justice HOLMES, speaking for this Court, said in his characteristic way, in referring to the historic defini-

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between persons having a special relationship such as the relationship of donor and donee. *Taft* v. *Bowers*, 278 U. S. 470 (1929). It is unsettled whether or to what extent such shifting may occur where the relationship is that of divorced husband and wife. *Cf. Gould* v. *Gould*, 245 U. S. 151 (1917); *Douglas* v. *Willcuts*, 296 U. S. 1, 9 (1935); and *Daisy M. Twinam*, 22 T. C. 83 (1954).

tion: "We see nothing to be gained by the discussion of judicial definitions." But the income held to have been realized in the *Kirby* case resulted from the taxpayer's financial transactions and activities deliberately undertaken, involving the use of its capital, and it could easily be held to come within the broad meaning of the source language of the historical definition. Indeed, the only court decisions which cannot be justified under this definition are the recent decisions holding Section 16(b) payments and punitive damages to be taxable income.

This Court has never embraced the idea that all accessions to wealth constitute taxable income unless specifically excepted by statute. On the contrary, this Court has specifically held that certain accessions to wealth, not specifically excluded from gross income by Section 22(b) of the Code, do not constitute gross income. *Brown Shoe Co.* v. *Commissioner*, 339 U. S. 583 (1950) (contribution by community group to taxpayer to induce location of plant in community not income); and *Edwards* v. *Cuba R.R. Co.*, 268 U. S. 628 (1925) (subsidy received by taxpayer from Cuban Government to induce railway construction not income). *Cf.* also, *Commissioner* v. *Inland Finance Co.*, 63 F. 2d 886 (9th Cir. 1933) (forfeited stock subscriptions not income to the corporation); and *E. H. Clark*, 40 B. T. A. 333 (1939) (receipt by taxpayer of an amount from his tax counsel as compensation for loss suffered on account of erroneous tax advice given taxpayer not income).

Since 1922, the Treasury Regulations have combined the definition of gross income included in Section 22(a) of the Code with the historic definition of income as expanded in *Eisner* v. *Macomber*. (U. S. Treas. Reg. 62, Art. 31, issued under the Revenue Act of 1921; and U. S. Treas. Reg. 111, Sec. 29.22(a)-1 (1943).) During all this period the Treasury Regulations have not been changed in this respect. There is no evidence so far as we know that Congress

is dissatisfied with this historical concept of income. Indeed, the latest evidence indicates the contrary.[4]

This historic concept has been generally accepted. The Committee on Terminology of the American Institute of Accountants, in commenting upon it, has stated that it conforms closely to the accounting concept and is appropriate for adoption by accountants for general application. See *Accounting Research Bulletin No. 9,* American Institute of Accountants, May 1941, p. 72; Thomas W. Leland, *Contemporary Accounting,* 1945, Chapter 3, p. 1. With such a consistent, long-standing recognition of the basic characteristics of income for the practical purposes of taxation through repeated reenactments and amendments of the statute, it is submitted that if any change in those characteristics is to be made at this late date it should be proposed by Congress and not by the courts.

We need not here dispute either the notion that the Congress could tax accessions to wealth that are not income but are "gains" or the notion that Section 22(a) of the Internal Revenue Code represents the exercise by Congress of the full measure of its constitutional authority to impose a tax upon income. For Congress has not attempted to tax anything except income and has not sought to include in gross income any item which by its nature is not income, and, as we contend, a Section 16(b) payment is not income to the recipient. Yet there is a lurking question whether there is not a borderline area in which the Court could say that, though the nature of an item may be in doubt, its belated inclusion in an income tax would be so unusual that Congress should expressly state in the statute that it really desires the item to be taxed. *Cf. Helvering* v. *Griffiths, supra; United States* v. *Supplee-Biddle Hardware Co.,* 265 U. S. 189, 195 (1924); and *cf.* also *Towne* v. *Eisner,* 245 U. S. 418, 425 (1918),

[4] In the Internal Revenue Code of 1954, in Subchapter B, Part II, Section 74, Congress deliberately excluded from gross income amounts received as prizes and awards made primarily in recognition of religious, charitable, educational, artistic, literary or civic achievement if "the recipient was selected without any action on his part" and "is not required to render substantial future services as a condition to receiving the prize or award".

in which Mr. Justice HOLMES, in considering the meaning of income under the 1913 Revenue Act, said that "it is not necessarily true that income means the same thing in the Constitution and the act."

We do not mean to suggest in what has been said that this Court should be hidebound by a literal interpretation of its own earlier definition. This Court has of course, since adoption of the definition, wisely developed and refined the law with respect to some aspects of income with which we are not here concerned, namely, with respect to questions of sufficiency of severance, time of realization, claim of right and imputed income. See *e. g., Helvering* v. *Bruun,* 309 U. S. 461 (1940), and *Rutkin* v. *United States, supra.* But so far as we are aware, with the exception of the recent Section 16(b) and punitive damage cases, there is no decision of this Court or of any other Court in which a receipt has been held to be income which would not be income under a reasonable interpretation of the source rule, the "capital" and "labor" language, of the historical definition. And we submit that the importance of stability in the highly practical law of taxation should dictate that in so far as the required sources of derivation are concerned no change should be made at this late date in the established meaning of income for tax purposes, at least without some indication of a Congressional desire for a change.

E. *The only rational dividing line between what is and what is not income for Federal income tax purposes is essentially the line which this Court has heretofore drawn. The arguments for departing therefrom given by the Court below and the Courts in the* Obear-Nester *and* Park & Tilford *cases prove too much.* Where is the dividing line to be drawn between what is and what is not income for Federal income tax purposes if it is not drawn essentially along the lines this Court has heretofore indicated?

Surely it is not to be drawn haphazardly on a case-by-case basis, as suggested by the Court below, without any

rational guiding rules whatever other than the particular court's hunch as to popular understanding or its notion concerning public policy considerations. The only ground given by the Court below for holding the Section 16(b) payment taxable was based less on reason than on feeling. Having cast off historical restrictions and having observed that "Policy considerations may in the end play a decisive or persuasive role in the punitive damage . . . cases" (R. 15), the Court explained its conclusion by saying (R. 17):

> "So now, if we consider the words 'gains or profits and income from any source,' 'in their plain popular meaning,' as we think they should be, how can there be any doubt that these Section 16(b) payments are 'income'?
>
> "Petitioner had unrestricted discretion to use the funds for any purpose whatsoever; they were in no sense donations or contributions to capital, or payments by way of restoration of lost capital, or compensation for any loss suffered by petitioner."

Under this language, unless some judicial hunch as to policy considerations should dictate otherwise, any receipt of unrestricted funds not falling within the indicated exceptions would constitute income. Yet is there not real doubt, taking the statutory words in their "plain popular meaning", that all such enrichments should be considered income? The Court below thought it of no help to talk about "windfall" or "penalty" (R. 16). But as the Court said in the *Glenshaw Glass* case (211 F. 2d at 933): "We do believe that a 'windfall' . . . would not be regarded as 'income' within the terms of common speech. . . . We believe that the ordinary man regards income as something which comes to him from what he has done, not from something which is done to him." The latter Court said, further (211 F. 2d at 931); "A single gift of money or property probably should not be treated as taxable income even if the specific exemption granted to gifts by statute were unavailable." Indeed, gifts and inheritances have

never before been seriously thought of as income. *Cf. Helvering* v. *American Dental Co.*, 318 U. S. 322 (1943) and *Bogardus* v. *Commissioner*, 302 U. S. 34 (1937). The fact that the statute expressly excludes gifts, bequests, devises and inheritances from gross income is not significant, for the statute also excludes a series of other receipts that are also generally thought to be classifiable in whole or in part as capital rather than as income. Thus there are excluded, for example, in addition to gifts, bequests, devises and inheritances, amounts received under a life insurance contract paid by reason of the death of the insured, a considerable portion of annuity payments, and compensation for personal injuries or sickness.

The Court in the *Obear-Nester* case went even further than the Court below in the present case. Agreeing in general with the views expressed by the Court of Claims in the *Park & Tilford* case, it concluded that Section 16(b) payments and punitive damages should both be considered income for these reasons:

(i) the income tax is based upon ability to pay;

(ii) there is no rational connection between the sources of a taxpayer's gain and his ability to pay—the question is whether he has realized an economic gain from whatever source which leaves him better able to contribute to the support of the government;

(iii) the reason gains from some sources are not taxable is not that they do not constitute income but rather that the Constitution or Congress forbids the collection of tax upon income from these particular sources;

(iv) if gain not derived from capital or labor is excluded from taxation, the burden on income derived from these sources will be all the greater; and

(v) if Congress were to select one kind of receipt of money which above all others would be a fair mark for taxation it might well be windfalls.

The Court, though speaking of "gain", does not in fact define that term; but the term obviously cannot have been intended to include anything that is not income within the meaning of the Sixteenth Amendment. The Court in effect says that every receipt of every kind in money or its equivalent which increases ability to pay constitutes income, and that under the Sixteenth Amendment there may be taxed as income, without apportionment, all gifts, all contributions to capital, all forfeited stock subscriptions, all inheritances, all windfalls and all other realized accessions to wealth whether fortuitous, accidental or otherwise. Yet the only reasons the Court gives for this conclusion are reasons that are no less applicable to a capital levy than to an income tax. Ownership of capital affects ability to pay taxes no less than income; there is no rational connection between the sources of a taxpayer's assets and his ability to pay. Naturally, if capital assets and capital accretions are not taxed, the tax burden on income must necessarily be greater. If Congress were to consider windfalls a fair mark for taxation above all other receipts, it does not follow that they can or should be taxed as income. There is, indeed, no basis for assuming Congress would not have specifically exempted from income tax windfalls and penalties along with gifts and inheritances if it had thought of them.

The points made by the Court in support of its conclusion therefore beg the question and are beside the point. They may bear upon the nether limit of the sheer and absolute power of a sovereign to tax but they shed no light on the nature of an income tax. The Court's view of what constitutes income goes far beyond historical conceptions in this country and in England and Canada, is inconsistent with prior decisions of this Court and is not in accord, it is submitted, with the common understanding of the meaning of

income. If we are correct in believing that the ordinary taxpayer would not think of every personal economic enrichment that comes to him without consideration or effort as income, the adoption of such a notion for purposes of a self-assessing income tax would be not only unwarranted but unwise. How many people would conceive it possible, for example, that Congress could if it wished impose an income tax, as distinct from an inheritance tax, on their receipt of property by bequest, devise or inheritance?

The grasp of the income tax is properly very broad—broader in the United States than in Great Britain or in our English-speaking neighbor, Canada. But in the popular mind, we submit, it does not reach and subject to progressive income taxation, at the whim of Congress, such types of receipts as gifts, bequests, devises and inheritances, forfeited stock subscriptions, windfalls and penalties of the character under consideration here and other windfalls including treasure-trove accidentally found. Never until recently in the long history of Federal income taxation has any attempt been made so far as we know to tax the accidental finding of treasure-trove as income. But following his success in the Court of Claims and the Tax Court in the Section 16(b) cases, the Commissioner ruled, contrary it is submitted to common belief, that the finding of treasure-trove is the receipt of taxable income (no indication being given as to the effect of the finder's rejection of his find). See *Revenue Ruling 61*, 1953-1 C. B. 17. This is not surprising. For if the decision below is correct, it is difficult to see why all enrichments, including *a fortiori* the accidental finding of treasure-trove, would not constitute income. A finder at least does something and his find if he accepts it is the result of his own free and uncontrolled action.

II.

CONCLUSION

For the foregoing reasons, the decision of the Court below is incorrect and should be reversed.

Respectfully submitted,

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December, 1954.